

LAW ENFORCEMENT OFFICERS' AND FIRE FIGHTERS' PLAN 2 RETIREMENT BOARD

Payment of Medical Expenses Initial Consideration

December 16, 2009

1. Issue

Federal law places a number of requirements on the payment of medical expenses out of a qualified pension plan in order for the payments to be non-taxed. The LEOFF Plan 2 Retirement Board (L2B), Department of Retirement Systems (DRS), Washington State Investment Board (WSIB), and Office of the State Actuary (OSA) will develop coordinated payment and accounting procedures to meet these federal requirements.

2. Staff

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3. Members Impacted

There are 28 survivors whose payments of premium rates to the Washington State Health Care Authority are paid by the LEOFF Plan 2 trust fund.

4. Current Situation

The LEOFF Plan 2 pension fund pays cost the of participating (premiums) in a PEBB health insurance plan by survivors of all LEOFF Plan 2 members killed in the course of employment. These benefits are non-taxable as they are considered in the same nature as Workers' Compensation benefits. The survivors of members killed in the line of duty prior to January 1, 1998, as well as all future survivors, are eligible to participate in PEBB health insurance plans.

5. Background Information and Policy Issues

Legislation passed in 2006 (SB 6723) provided additional benefits to the surviving spouse and dependent children of LEOFF Plan 2 members who are killed in the line of duty by paying the Public Employees' Benefits Board (PEBB) health care premium rates to the Washington State Health Care Authority pursuant to RCW 41.05.080. RCW 41.05.080 allows for continued participation in insurance plans and contracts through PEBB for surviving spouses and dependent children of members killed in the line of duty. The payment of the medical expenses for the surviving spouse and dependent children are currently paid directly out of the pension trust fund. These benefits are non-taxable as they are considered in the same nature as Workers' Compensation benefits.

Internal Revenue Code - 401(h) Accounts

Federal law places a number of requirements on the payment of medical expenses out of a qualified public pension plan. Section 401(h) of the Internal Revenue Code (IRC) allows a pension or annuity plan to provide for payment of benefits for sickness, accident, hospitalization and medical expenses for retired employees (by definition this would include survivors), their spouses and dependents¹. The contributions to a 401(h) accumulate tax-free. In addition to tax-free accumulation, the medical benefits provided through a 401(h) account are also tax-free.

IRC 401(h) Requirements

A 401(h) is a qualified annuity plan set up under a defined benefit pension plan and can be used to pay various non-pension benefits, such as certain medical expenses. As a vehicle under the IRC that may be used for payment of tax-free medical expense benefits, there are several requirements that the 401(h) account must meet. A high-level description of the 401(h) requirements is provided below.

Benefits. A pension or annuity plan may provide retiree medical benefits, through a section 401(h) account, including payment of benefits for sickness, accident, hospitalization and medical expenses. The plan must specify the medical benefits described in section 401(h) which will be available and must contain provisions for determining the amount which will be paid.

Section 401(h); Treas. Regs. 1.401-1(b)(1)(i), 1.401-14(a) and (c)(1).

Coverage. The plan must provide that medical benefits are only provided for retired employees, their spouses and dependents. To be "retired" for purposes of eligibility to receive medical benefits described in section 401(h), an employee must be eligible to receive retirement benefits provided under the pension plan, or else be retired by an employer providing such medical benefits by reason of permanent disability. For purposes of the preceding sentence, an employee (even one who is past normal retirement age) is not considered to be "eligible to receive retirement benefits provided under the plan" if he is still

¹ <http://www.irs.gov/pub/irs-tege/chap801.pdf>, 11/23/09

employed by the employer and a separation from employment is a condition for receiving the retirement benefits.

Section 401 (h); Treas. Regs. 1.401-14(a), (b) (1) and 1.401(a)(4)-1(c)(14).

Separate Accounts. Where medical benefits described in section 401(h) are provided under a qualified pension or annuity plan, the plan must provide that a separate account must be established and maintained with respect to contributions to fund such benefits. The separation required by this section is for recordkeeping purposes only. Consequently, the funds in the medical benefits account need not be separately invested.

Section 401(h)(2) and Treas. Reg. 1.401-14(c)(2).

Reasonable and Ascertainable Contributions. The contributions for medical benefits provided by the section 401(h) account must be reasonable and ascertainable, and the plan must contain provisions for determining the amount which will be paid. These requirements will not be satisfied unless the terms of the plan specify the amount of benefits and the time period with respect to which benefits will be paid. Where there are other potential sources of payment of medical benefits such as a welfare benefit fund or the general funds of the employer, the plan must be specific as to how the benefits payable from the section 401(h) account are coordinated with benefits payable from other sources. The plan may not allow for employer discretion in the timing and amount of benefit payments. The employer must, at the time a contribution is made, designate that portion of such contribution allocable to the funding of medical benefits.

Section 401(h)(3) and Treas. Reg. 1.401-14(c) (1) and (3).

Non-Diversion. A plan may not permit funds in the retiree medical benefits account to be used for any retirement benefits. A plan allowing such a payment does not satisfy the requirements of section 401(h) and will not qualify under section 401(a). However, the payment of any necessary or appropriate expenses attributable to the administration of the medical benefits account does not affect the qualification of the plan.

Section 401(h)(4) and Treas. Reg. 1.401-14(c)(4).

Reversion. The plan must expressly provide that any amounts that are contributed to fund medical benefits described in section 401(h) and that remain in the medical benefits account upon the satisfaction of all liabilities arising out of the operation of the medical benefits portion of the plan are to be returned to the employer.

Section 401(h)(5) and Treas. Reg. 1.401-14(c)(5).

Forfeiture. The plan should provide that in the event an individual's interest in the medical benefits account is forfeited prior to termination of the plan an amount equal to the amount of the forfeiture must be applied as soon as possible to reduce employer contributions to fund the medical benefits.

Treas. Reg. 1.401-14(c)(6).

Employer or Employee Contributions. Contributions to provide the medical benefits described in section 401(h) may be made either on a contributory or noncontributory basis, without regard to whether the contributions to fund the retirement benefits are made on a similar basis. Thus, for example, the contributions to fund the medical benefits may be provided for entirely out of employer contributions even though the retirement benefits under the plan are determined on the basis of both employer and employee contributions or vice versa.

Treas. Reg. 1.401-14(b)(3).

Transfers. The plan must contain provisions that meet the requirements of section 401(h) in order for the plan to meet section 420 on the transfer of assets to retiree health accounts. Code section 420 permits a “qualified transfer” of pension assets of a defined benefit plan, subject to several requirements on when and how much may be transferred.

*Section 420(e)(3).*²

Additional Duties and Future Actions

Implementing a 401(h) account would require new duties and future actions by the LEOFF Plan 2 Retirement Board (L2B). A 401(h) account would require coordination with strategic partners including Department of Retirement Systems (DRS), Washington State Investment Board (WSIB), and Office of the State Actuary (OSA). The implementation and administration of a 401(h) account would be coordinated by an interagency agreement. Issues to coordinate would include, for example, setting-up and administering the account, investment policy for the account assets, and measuring and reporting plan assets and liabilities. Future actions that could be required of L2B include determining possible transfer of assets from the pension plan to the 401(h) and establishing contributions to the 401(h) account.

² <http://www.irs.gov/pub/irs-pdf/p11433.pdf>